The advantages of using bond ETFs over individual bonds

Vanguard Research Note | July 2020

- Bond exchange-traded funds (ETFs) can offer significant advantages compared with building a portfolio of individual bonds.
- These advantages can include greater diversification, liquidity and transparency, easier reinvestment of capital and income, and more consistent risk characteristics.
- Bond ETFs also tend to be lower cost, which can have a large impact on net returns, particularly in a low-yield environment.

For most investors, bond ETFs offer advantages over individual bonds.[1]

These advantages can include greater diversification, easier reinvestment of capital and income, and more consistent risk characteristics. In addition, bond ETFs tend to be lower cost for most investors which, all else being equal, should translate into higher net returns.

Portfolios of individual bonds also have their advantages, but most of them relate to control over security-specific decisions and tend to come with an associated "control premium."[2]

Advantages of bond ETFs

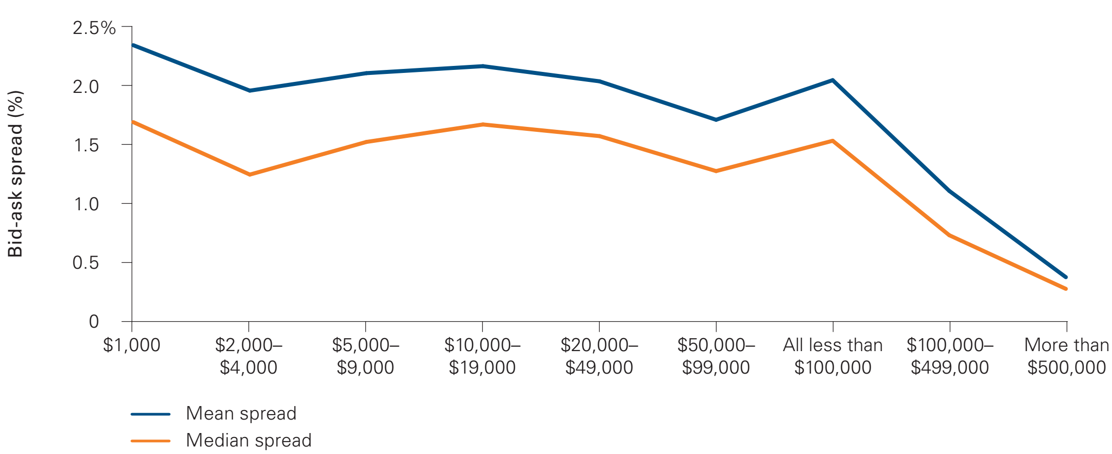
Diversification. Global investment-grade fixed income markets play an important role in investment portfolios as a stabilizing force to diversify riskier investments such as equities.

Access to a well-diversified portfolio of bonds is one of the key advantages to owning a bond ETF, as is increased simplicity and ease of use. Through a single holding in a bond ETF, investors can access hundreds if not thousands of bonds that are diversified among issuers, credit quality and term structure.

Building such a portfolio takes the size and scale provided by a large portfolio, such as an ETF.

Low costs. In the current low-yield environment, investing costs matter more than ever. This is especially true for bond markets, where yields are below their historical averages and costs erode a larger share of returns than they have in the past. All else being equal, lower costs should translate into higher net returns and better performance.

Corporate bond spreads by trade size



Notes: Spreads by trade size are from November 2008 to April 2010 and taken from The Canadian Fixed Income Market 2014 report. Spread is defined as the log percentage-point difference between the trade price and the next unpaired interdealer trade, adjusted for intervening changes in the general bond market, as captured by the exchange-traded fund with ticker LQD (for investment-grade) or JNK (for high-yield bonds). The Trade Reporting and Compliance Engine (TRACE) system truncates reported trade sizes at $1 million for high-yield bonds and $5 million for investment-grade bonds.

Source: Vanguard calculations, using data from the Ontario Securities Commission (OSC).

1 This research note focuses on the advantages of using bond ETFs over individual bonds. The risks and benefits of owning bonds as an asset class are generally beyond the scope of this note.

2 The control premium refers to generally higher (or additional) transaction costs, lower liquidity, more limited return opportunities, and higher bond portfolio risk.

Bond ETFs tend to have greater economies of scale than most individual bond portfolios built by advisors. This size advantage should generally translate into lower execution costs. The figure on the previous page illustrates this by showing spreads on corporate bond trades by size, which notably decline as trade size increases.

ETFs also tend to have greater bargaining power than individual and smaller-scale investors because they have access to a larger number of dealers and counterparties. This access can translate into more favourable pricing.

Liquidity and transparency. Since bond ETFs are listed on an exchange and can be traded at any time during market hours, they tend to have more liquidity than a portfolio of individual bonds. They also have more transparency on pricing and what investors are bidding and asking. Data on duration, credit ratings and yield are also readily available for ETFs.

Ease of capital and income reinvestment. Compared with individual bonds, bond ETFs provide more timely investment of initial principal and periodic income cash flow.

Consistent risk characteristics. Bond ETFs provide more consistent risk characteristics (such as portfolio duration) than individual bonds, making liquidations, especially partial liquidations, much easier.

Advantages of individual bonds

Portfolios of individual bonds also have their advantages. Ironically, one commonly cited reason for using them—greater protection from rising interest rates—is not among their advantages. This is because when the principal paid at maturity is reinvested, as it often is in laddered individual bond strategies, the resulting portfolio is functionally similar to a pooled fund, such as an ETF.

Instead, the advantages of using a portfolio of individual bonds relate to control over security-specific decisions and tend to come with an associated "control premium," which is reflected in generally higher transaction costs, lower liquidity and higher overall portfolio risk. This premium tends to be more pronounced for buyers of corporate bonds and mortgage-backed securities than for buyers of government bonds.

Low-cost bond ETFs can add value to client portfolios

Bond ETFs hold a number of advantages over individual bond portfolios in terms of diversification, cost, liquidity, transparency, more consistent risk characteristics, and cash flow treatment along with the expertise of an investment management team.

Low-cost and diversified ETFs provide building blocks that can help advisors when setting and maintaining their clients' overall asset allocation strategies.

Reference

Bennyhoff, Donald G., Scott J. Donaldson and Ravi G. Tolani, 2012. *A Topic of Current Interest: Bonds or Bond Funds.* Valley Forge, Pa.: The Vanguard Group.

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Date of publication: July 2020

BOIBNT_CA_072020